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SUBJECT: ECUADOR ECON WEEKLY: FALLING FDI, REVISED PRICE CONTROLS, SOCIAL SECURITY TO INVEST IN GOVERNMENT PROJECTS

REF: A) Quito 191 B) 07 Quito 2277 C) Quito 36
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¶1. (U) The following is a weekly economic update for Ecuador that reports notable developments that are not reported by individual cables.

Investment Outflows Driven by the Petroleum Sector
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¶2. (SBU) Net foreign direct investment (FDI) in Ecuador declined 34% in 2007 ($178 million vs. $271 million in 2006). The first three quarters of 2007 appeared to reflect a modest recovery (reftel a) from already poor performance in 2006. However, the fourth quarter of 2007 showed a net outflow of almost $300 million. Net FDI (inflows minus outflows) for 2007 was the lowest in at least six years, and down sharply from the peak of $871 million in 2003.

¶3. (SBU) The petroleum sector accounted for the large drop in FDI in the last quarter of 2007. The mining/petroleum sector registered $483 million in outflows for the quarter, more than erasing the small net inflows in the first part of the year (the sector for the year as a whole had $418 million in net outflows). We understand that much of the outflow was repatriated profits, which some analysts say is an annual practice. However, the investment situation was clearly aggravated when the windfall income tax was increased to 99% in October (reftel b). Almost all the petroleum companies froze their investment plans after the announcement, so they did not have any incentive to retain profits in country to pay for future investments. In addition, we understand private drilling companies have shipped many of their drilling rigs out of Ecuador, which may show up as an investment outflow, and clearly signals that the private petroleum companies will not be resuming investment in the near future.

Price Controls for Milk

¶4. (U) On April 23, the Correa administration made its first adjustment to the milk price controls it imposed in January (reftel c). It raised the maximum prices by five cents/liter in several categories, and eliminated price controls on the most upscale category of milk, long life ultrapasteurized milk in one liter boxes. It did, however, impose price controls on ultrapasteurized milk in less expensive packaging, leading one producer to complain that he may have to stop producing the less expensive version.

Social Security to Invest in Government Projects
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¶5. (U) The Ecuadorian Social Security Institute (IESS) announced that it will invest $578 million of its assets in petroleum, electricity and mining projects. It will reportedly invest $100 million in developing a field in Block 15 (which was seized from Occidental Petroleum in 2006) and $50 million in Coca Codo Sinclair, Ecuador's largest hydroelectric project. The Minister of Mines and Petroleum suggested that IESS could invest in the to-be-established state mining company (reftel d).

¶6. (SBU) Comment: In part, it appears that the government would like to use IESS savings to fund some of its ambitious investment program, but it also looks like the IESS board is looking for potentially better returns. Currently, the pension fund is invested in Central Bank accounts and government bonds, which garner a low rate of return, and the government has reduced the volume of bonds that it is placing with IESS. At this time, the government has more cash than it can spend, given its limited ability to implement investment programs, high petroleum revenue and increased control over the old petroleum funds. But if it can ever increase its capacity to implement projects, it may need to rely on IESS funds as well.

Speculation about New Debt Issuance

¶7. (SBU) Financial analysts report there is a growing expectation in Ecuador's financial community that Finance Minister Fausto Ortiz might restructure some of Ecuador's external debt in 2008 or 2009, although there is no suggestion he will do so in the near future. Ecuador risk spreads fell after the GOE abandoned suggestions it might default and instead regularly paid its debt obligations. Ortiz publicly suggested that the GOE may be ready to issue new bonds in 2009. If so, Ecuador could use the new bonds to replace a

portion of its outstanding commercial debt, which carry relatively high interest rats; two of the issuances included call options that give the government the right to retire some of the debt. Visiting investment analysts have said that there might be appetite for a new Ecuadorian placement, but only after investors have seen the new constitution.

Petroecuador Unable to Spend Its Investment Budget

¶8. (U) Petroecuador reported low budget spending for the first two months of 2008. As a result, on April 16, Petroecuador's Board of Directors announced the creation of a budget-monitoring commission. According to the company, it had budgeted $115.3 million in investment for January and February, or 7% of total investment planned for 2008 ($1.7 billion). Instead, it spent only $49.6 million on investment. Also between January and March, Petroecuador spent $577.9 million on current expenses; $435 million of this was used to import oil derivatives. The Ministry of Petroleum and Mines expressed frustration that the state-owned company has not been able to move forward with its joint rehabilitation of the mature Sacha field with Venezuelan petroleum company PDVSA.

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